72-1539

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Supreme Court, U. S.
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IN THE

Supreme Court of the United States

October Term, 1972.

No. 72-1539

KARL and HILDA HOPE,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

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KARL AND HILDA HOPE,

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

Karl and Hilda Hope hereby petition that a writ of certiorari issue to review the judgment[1] and opinion of the United States Court of Appeals for the Third Circuit, entered in the above-entitled case on January 9, 1973.[2]

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1. Only two judges participated in the decision as the third judge who heard the argument died prior to the issuance of the opinion of the United States Court of Appeals for the Third Circuit.

2. A timely petition for rehearing was filed and denied on February 14, 1973.

I.

OPINIONS BELOW.

The findings of fact and opinion of the United States Tax Court (R 263a-304a) [3] are reported in 55 T. C. 1020 and are printed in Appendix C hereto, *infra*, pp. A18-A42. The opinion of the Court of Appeals is reported at 471 F. 2d 738 and is printed in Appendix B hereto, *infra*, pp. A3-A14.

II.

JURISDICTION.

The judgment of the Court of Appeals was entered on January 9, 1973, and a timely petition for rehearing was denied on February 14, 1973, Appendix B, *infra*, pp. A16-A17. On March 5, 1973 the Court of Appeals granted petitioners' motion to stay issuance of mandate pending filing of this petition for writ of certiorari. The jurisdiction of this Court is invoked under 28 U. S. C. § 1254(1).

III.

STATEMENT OF THE QUESTION PRESENTED.

In July, 1960 Karl Hope (Karl) sold 206,400 shares of Perfect Photo, Inc. (Perfect Photo) common stock for $4,000,032 or $19.38 per share. Shortly after the sale, in the same tax year, Karl demanded the transaction be rescinded and tendered back the purchase price having concluded, in good faith, that he was fraudulently induced to make the sale at a price substantially below the market

3. As used herein, the letter "R" preceding specific pages refers to the "Appendix to the Briefs" in the Court of Appeals, a copy of which has been deposited with the Court.

value of the stock. In December, 1960, in the same tax year, Karl, acting upon the advice of counsel that he had reasonable prospects of recovery, filed suit in the United States District Court for the Eastern District of Pennsylvania seeking rescission on the ground of fraud.

The Commissioner nevertheless determined that Karl realized taxable gain on the net proceeds from the sale of 206,400 shares of Perfect Photo stock in 1960 on the ground that Karl held the proceeds under a "claim of right". The Tax Court and the Court of Appeals for the Third Circuit upheld the Commissioner. However, the Tax Court explicitly noted that its decision was in conflict with a decision of the Court of Appeals for the District of Columbia (Appendix C, *infra*, p. A34). Therefore, the question presented is:

> When, in the year of receipt, a taxpayer, in good faith, (a) disclaims his right to the proceeds of a sale, (b) demands rescission and tenders the proceeds to the purchaser, and (c) when rejected, with reasonable prospects of recovery, institutes a suit to compel rescission, which suit is pending at the end of the taxable year, are the proceeds of the sale includable in income in the year received?

IV.

STATUTES AND REGULATIONS INVOLVED.

The statutory provisions involved are §§ 61(a) and 451(a) of the Internal Revenue Code of 1954, respectively 68A Stat. 17, 26 U. S. C. § 61(a) and 68A Stat. 152, 26 U. S. C. § 451(a). Both sections are printed in Appendix A, hereto, *infra*, pp. A1-A2.

V.

STATEMENT OF THE CASE.

The petitioners, husband and wife, filed calendar year tax returns on the cash receipts and disbursements method of accounting (Appendix C, *infra*, p. A19; R 265a-266a). On July 27, 1960 Karl sold 206,400 shares of Perfect Photo common stock to Harriman Ripley & Co., Inc. (Harriman Ripley) for $4,000,032 or $19.38 per share (Appendix C, *infra*, p. A24; R 274a). Several weeks after the sale (R 188a-189a) and well within the year of receipt, Karl demanded the transaction be rescinded and tendered back the purchase price having concluded, in good faith, that he had been fraudulently induced to make the sale at a price substantially below the market value of the stock by the misrepresentations of two officers of Perfect Photo which were furthered by the failure of Harriman Ripley to apprise him of the true nature of the transaction (Appendix B, *infra*, p. A6; R 100a-103a, 134a, 177a-189a, 197a, 229a-233a, 240a, 245a-246a, 248a-249a, 277a).

When his efforts to obtain rescission failed, Karl consulted an attorney who attempted unsuccessfully to negotiate a rescission of the sale (R 189a-192a). On December 21, 1960 Karl, acting upon the advice of his attorney that a fraud had been perpetrated and that he had reasonable prospects of recovery, filed a complaint in the United States District Court for the Eastern District of Pennsylvania against Harriman Ripley and the officers alleging a conspiracy to defraud him and seeking a rescission of the sale (Appendix B and C, *infra*, pp. A6-A7 and A26-A27 respectively; R 191a-193a, 277a-288a).[4] The lawsuit was pending

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4. The lawsuit was settled on March 24, 1961 under the terms of which Karl received options until December 31, 1961 to reacquire 154,800 of the shares originally sold at the original sales price of

at the end of 1960 (Appendix B and C, *infra*, pp. A6 and A27 respectively; R 279a).

In his 1960 tax return Karl disclosed the July, 1960 transfer but did not include any gain in income for that year on the theory that because of his disclaimer of right to the proceeds, his tender back of the purchase price, and suit for rescission, the transfer was not a completed sale upon which gain was "recognized" in 1960 (Appendix B and C, *infra*, pp. A8 and A30 respectively).[5]

The Commissioner determined that Karl realized a taxable gain in 1960 of $3,939,712 on the sale of the entire 206,400 shares of Perfect Photo stock and assessed a deficiency of $985,459.00 on the basis that the sale was a closed and completed transaction in 1960 and that Karl held the proceeds under a "claim of right", and was therefore taxable under the principles of annual accounting as provided in § 451(a) of the Internal Revenue Code of 1954 (Appendix B, *infra*, pp. A8, A10).[6]

The Tax Court upheld the Commissioner in respect of 1960 and the Third Circuit affirmed, holding that Karl's attempted rescission and eventual suit for rescission in

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4. (Cont'd.)
$19.38 per share (Appendix C, *infra*, p. A30; R 279a-281a). Karl was also granted irrevocable proxies to vote the shares during the term of the options (Appendix C, *infra*, p. A28; R 280a). While the options and proxies did not provide the right to receive dividends in respect of the stock, Perfect Photo had never paid any dividends nor was there any likelihood that the company would do so during the option period (R 199a-200a, 207a-208a). Karl exercised the options on December 29, 1961 (Appendix C, *infra*, p. A30).

5. In his 1961 tax return Karl reported a sale of 51,600 shares of Perfect Photo stock (the difference between 206,400 and 154,800 shares) and included the net proceeds from the sale in income (Appendix C, *infra*, p. A31).

6. In the alternative, the Commissioner determined that Karl realized a taxable gain in 1961 of $986,098 on the sale of 51,600 shares of Perfect Photo stock (Appendix C, *infra*, p. A31).

1960 did not postpone the realization of taxable gain in 1960 (Appendix B and C, *infra*, pp. A9 and A31-A34, respectively). However, the Tax Court explicitly noted that its decision was in conflict with a decision of the Court of Appeals for the District of Columbia in *Sohio Corp. v. Commissioner*, 163 F. 2d 590 (D. C. Cir., 1947) [7] which held a taxpayer was not taxable on income received when in good faith he voluntarily disclaimed his right to the income in the year of receipt. The Third Circuit's affirmance thus creates a clear conflict between the Courts of Appeals for the Third Circuit and the District of Columbia.

It is on the basis of this conflict and the conflict with the concept of the claim of right doctrine as expressed by this Court in *E. E. Healy v. Commissioner*, 345 U. S. 278 (1953) as well as the importance for the proper administration of the Federal tax laws of clarifying the application of the annual accounting doctrine in situations in which the taxpayer, in good faith, disclaims his right to income, that a writ of certiorari is sought herein.

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7. The Tax Court asserted that "* * * the holding that an accrual basis taxpayer does not derive income with respect to an amount actually received and not subject in the year of receipt to an offsetting obligation to refund is in our opinion incorrect." (Appendix C, *infra*, p. A34). While the Tax Court noted that *Sohio* filed its returns on the accrual basis of accounting, this was clearly not made a basis for distinguishing the case inasmuch as the claim of right doctrine applies equally to accrual basis taxpayers. *North American Oil Consolidated v. Burnet*, 286 U. S. 417 (1932); *American Automobile Assn. v. U. S.*, 367 U. S. 687 (1961).

VI.

REASONS FOR GRANTING THE WRIT.

A. The Decision of the Third Circuit Below Is in Direct Conflict With the Decision of the Court of Appeals for the District of Columbia in *Sohio Corp. v. Commissioner*, 163 F. 2d 590 (D. C. Cir., 1947).

The basic issue in this case is whether a taxpayer, who in the year of receipt, in good faith, voluntarily disclaims his right to funds received and tenders such proceeds back to the purchaser and when such tender is rejected brings suit to compel rescission of the underlying transaction, must include such funds in income in the year received.[8]

The Commissioner based his determination exclusively upon the claim of right concept and the annual accounting doctrine to the effect that when funds are received and held by a taxpayer under a claim of right he must be held taxable thereon in the year of receipt and the repayment of the funds in a later year cannot, consistent with the annual accounting concept, justify exclusion of the funds from income in the year of receipt. *North American Oil Consolidated Co. v. Burnet*, 286 U. S. 417 (1932). These principles of annual accounting are embodied in § 451(a) (Appendix A, *infra*, p. A2).

In the instant case, however, the sale proceeds were not held under a "claim of right" for prior to the end of the year in which the sale took place, Karl in good faith

8. It was conceded by the Commissioner in oral argument before the Court of Appeals that the action was brought in good faith and at no time has he contested the fact that the suit had reasonable prospects of recovery, which fact is amply supported by the uncontroverted record below as well as the findings of the Pennsylvania Securities Commission (R 45a, 95a, 188a-189a, 248a, 277a-278a, 281a-282a).

fully disclaimed all right to the proceeds and instituted litigation to compel the purchasers to accept back the proceeds of the sale and to return the stock to him. In upholding the Commissioner, the Court of Appeals held that in order for Karl to come within the disclaimer exception to the claim of right doctrine and thus avoid the annual accounting provisions of § 451(a), he must have been under an existing and fixed liability to rescind the sale and repay the proceeds in 1960.[9] Hence, the crux of the issue is whether the judicially recognized "disclaimer of right" exception to the principles of annual accounting can result from a voluntary disclaimer made in good faith, or whether the disclaimer is required to be made under an existing and fixed liability to repay which is acknowledged by both parties.

The Sohio Case.

The decision of the Court of Appeals below, as the Tax Court recognized (Appendix C, *infra*, A34), is directly contrary to the decision rendered by the Court of Appeals for the District of Columbia in *Sohio Corp. v. Commissioner*, 163 F. 2d 590 (D. C. Cir., 1947) and moreover, totally misapprehends the conclusion reached in *Sohio, supra*.[10]

In *Sohio* the taxpayer was required by Illinois law to collect certain taxes from companies with which it did business. The taxpayer transmitted the taxes to the State after

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9. The Court below erroneously determined that in certain cases cited by petitioners the taxpayers were under a mutually acknowledged legal liability to make repayment. Appendix B, *infra*, pp. A10-A11. However, see discussion, *infra*, p. 13.

10. In addition to erroneously stating the facts of *Sohio, supra*, the Court of Appeals discussed the case in the context of § 1341, an issue not raised either before the Court of Appeals below or in *Sohio, supra*. It is significant, however, that the Court did not find *Sohio* under a liability to contest the constitutionality of the Illinois statute or to repay the collection fees in the year of receipt.

first deducting as the cost of collection a statutory collection fee equal to two percent (2%) of the amount so collected. Normally, such two percent (2%) collection fee would clearly be income to the taxpayer for performing a service for the State of Illinois.

During the periods at issue, 1941 and 1942, the taxpayer complied with the statute, collected the tax, remitting same to the State while retaining its collection fee, which fee it commingled with its general funds. In 1941, shortly after the initial collections were made, the taxpayer joined with others in contesting the constitutionality of the statute. In 1944 the statute was declared invalid by the Supreme Court of Illinois, and thereupon the taxes were refunded by the State to the taxpayer who in turn refunded them to the companies from whom they were originally collected, including an amount equal to the fees which had been retained by the taxpayer for its services.

The issue of whether these fees were taxable in 1941 and 1942, the years of receipt, was first raised by *Sohio* before the Tax Court as an affirmative issue. Prior to that time, unlike the petitioners herein,[11] it had used the monies in its business and for Federal Income Tax purposes treated them as taxable income. The actual cost of collection [12] had been deducted as an expense on its returns for the subject years (1941 and 1942) and was allowed by the

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11. At all times relevant, Karl, acting upon the advice of his attorney, maintained the sale proceeds in cash or marketable securities pending settlement of the dispute (R 277a).

12. The Illinois statute permitted the taxpayer to claim as compensation for collecting and remitting the tax, an amount equal to the costs involved but in all events not to exceed two percent (2%) of the amount collected. The taxpayer retained two percent (2%) as its fee apparently based upon its estimate of the costs. Actual costs subsequently determined at year end were less than the fees retained and were deducted as an expense.

Commissioner. The issue before the Appellate Court was the taxability of these fees in the years of receipt.

The Commissioner (as in the instant case) relied upon the annual accounting and claim of right doctrines. However, the Court of Appeals in *Sohio, supra*, found that the attitude of the taxpayer, as indicated by the suit filed, was the opposite of a claim of right, notwithstanding the fact that the taxpayer had an absolute right to the collection fees, and did not set aside the fees in an escrow or trust fund but commingled the amounts collected with its general funds and treated them as taxable income in the year of receipt on its Federal Income Tax returns as originally filed. Thus, solely because it joined the suit to have the statute declared unconstitutional, *Sohio*, at all relevant times, was nonetheless deemed to have disclaimed any right to the amounts collected and the Court found them not taxable in the year of receipt.

In analyzing *Sohio*, it must be noted that while the taxpayer alleged in the Tax Court and the Court of Appeals that its retention of the fees was under compulsion provided by the Illinois statute, the Opinion of the Tax Court makes it clear that this argument was wholly unsupported by the record (*Sohio Corporation, et al. v. Commissioner of Internal Revenue*, 7 T. C. 435, 438 (1946)). Hence, the Tax Court found that at all times relevant, *Sohio* was free to return the amounts retained as a collection fee. The Illinois statute only provided penalties for failure to collect and remit the tax (*Sohio Corporation, et al., supra*, at 7 T. C. 438). Any compelled retention was at best temporary resulting from *Sohio's* initial obligation to collect one hundred percent (100%) of the tax. Obviously, *Sohio* could have done as it pleased thereafter with its two percent (2%) collection fee and, instead of commingling it with its regular business funds, could have paid it back *pro*

rata to those taxpayers from whom it had collected the underlying tax.

Moreover, while *Sohio* believed the taxing act to be unconstitutional, it did not know that to be true. It is clear, as the Tax Court found, that if the State Court declared the statute constitutional, *Sohio* would have retained the fees (*Sohio Corporation, et al., supra,* at 7 T. C. 439). Thus, repayment or retention of the collection fee during the years the tax was collected was entirely within the control of the taxpayer. Notwithstanding, the Appellate Court, solely on the strength of *Sohio's* disclaimer by participation in the suit to have the statute declared unconstitutional, found that it had disavowed any claim to the fees retained and could not be required to include such fees in income in the years of receipt.

It follows from the above that *Sohio* and the instant case are substantively indistinguishable and are in unmistakable conflict. In fact, if anything, the renunciation of the taxpayer's right to proceeds in *Sohio, supra,* is much less compelling than in the case at bar. Karl disavowed any claim to the proceeds shortly after receipt and when his tender of the proceeds in rescission was refused, he brought suit to compel its acceptance. *Sohio,* notwithstanding its protests and participation in litigation, treated the funds as its own even though its dispute was with the State and not the parties from whom the funds were received. Thus, while *Sohio* voluntarily retained and expended the funds during the pendancy of the action, Karl, by virtue of his suit, held the proceeds of sale readily available since they were subject to a continuing tender which could be accepted at any time by the defendants to the action.

B. The Decision Below Conflicts With the Claim of Right Doctrine as Articulated by This Court in *E. E. Healy v. Commissioner*, 345 U. S. 278 (1953).

In *E. E. Healy v. Commissioner*, 345 U. S. 278 (1953), this Court likened the claim of right doctrine in taxation matters to the doctrine of adverse possession as applied in real estate matters. The maintenance of an adverse possession position in a real estate case obviously requires an affirmative claim hostile to the owner.

It is axiomatic that where a suit for rescission is brought before the end of the taxable year, in which the taxpayer demands the return of his property and tenders to the purchaser the entire purchase price, there is not an affirmative claim to the proceeds hostile to the owner, but rather a disclaimer of right which under the holding in *Sohio, supra*, and the rationale of *E. E. Healy, supra*, compels deferment of taxation. Hence, no case has applied the claim of right doctrine, where, as here, in the same year the funds are received, the taxpayer, in good faith, renounces his claim to the funds and recognizes his obligation to repay them.

It is judicially recognized that there is an affirmative exception to the claim of right doctrine where a taxpayer disclaims his right to funds in the year of receipt. Thus, just as it is essential that the holder of funds be asserting a "claim", *E. E. Healy, supra*, a "disclaimer of right" to such funds is the accepted counterpart to the doctrine and compels the deferment of taxation, *United States v. Merrill*, 211 F. 2d 297 (9th Cir., 1954); *Gaddy v. Commissioner*, 38 T. C. 943 (1962), *rev'd in part on other ground*, 344 F. 2d 460 (5th Cir., 1963); *Wilbur Buff v. Commissioner*, 58 T. C. 224 (1972); *Sohio Corp. v. Commissioner, supra.*

In holding that in order to fall within the exception to the claim of right doctrine the disclaimer of right must be

pursuant to an existing and fixed liability to rescind the sale as well as to repay the amount received, the Third Circuit has appended a qualification to application of the exception which this Court has never sanctioned, *E. E. Healy, supra.* It thus excludes from the exception any voluntary disclaimer irrespective of the circumstances under which it was made. The result is to make tax liability turn exclusively on the obstinacy of the purchaser and the slowness of the judicial calendar which prevented, in the case at bar, a final resolution of the issue in the year of receipt. This extraordinary ruling was announced without any precedent or the citation of any authority, case, textbook, law review article or otherwise, which supports such a legal result.

While it would appear clear, having made the disclaimer, that the holder of funds bears the concomitant obligation to repay those funds, it is a far different proposition to require the holder to be under a liability to commence action to rescind the sale before he may effectively disclaim. In none of the cases cited above was the *legal* obligation of the holder to repay made a prerequisite to application of the disclaimer exception. Moreover, it is apparent that the legality of the obligation to repay was often in doubt and viewed as irrelevant. *United States v. Merrill, supra; Gaddy v. Commissioner, supra; Sohio Corp. v. Commissioner, supra.*[13]

13. In *Merrill, supra,* prior to the Circuit Court's decision the local law was unclear as to whether the taxpayer had no legal right to the monies received. Clearly, the taxpayer would have had judicial support, if he had claimed the monies in the year of receipt. Compare *Bishop v. Commissioner,* 152 F. 2d 389 (9th Cir., 1945) with *Commissioner v. Larson,* 131 F. 2d 85 (9th Cir., 1942). Thus, the legality of the obligation to repay was not considered determinative of the effectiveness of the disclaimer. Similarly, in *Gaddy, supra,* the taxpayer's disclaimer of rental fees was sufficient to defer taxation even where there was never any enforceable obligation to repay or contractual undertaking as to the method of payment.

C. The Proper Administration of the Federal Tax Laws Requires This Court to Review the Decision of the Third Circuit.

The decision of the Third Circuit in this case substantially affects the administration of justice in tax cases. The Court failed to perceive that its decision resulted in a gross tax inequity which finds no support in the Internal Revenue Code or Regulations. In fact the Commissioner has promulgated a regulation which embraces the very principles espoused by the petitioners herein. Under Treas. Regs. 1.165-1(d)(2)(i) no loss is allowed where in the year of the event there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery. Thus, if there is a suit pending for recovery of the loss, it cannot be claimed for tax purposes.

Considering the Third Circuit's decision, if the stock Karl sold in a single sale consisted of two separately acquired blocks, each with a different basis so that he realized a loss on one and a gain on the other at the sale price realized, Karl would be prohibited from recognizing his loss on the one block because of the pending suit for rescission, while, under the instant holding, he would have to recognize his gain on the other block. Clearly, such a harsh and unjust result was never intended. In view of the Commissioner's regulation holding the transaction open when there is a loss followed by a reasonable prospect of recovery, the holding of the Third Circuit is untenable.

It is unjust and inconsistent for the Commissioner to characterize the transaction as closed in a case (such as the case at bar) where there is a gain, but open, under identical circumstances where there is a loss. Petitioners in their briefs before the Tax Court and the Court of Appeals, as well as in oral argument before the Court of Appeals, explicitly challenged the Commissioner to explain and justify

this paradox. Each time the Commissioner failed to do so, demonstrating a tax inequity too apparent to withstand judicial review.

Another pernicious result of the Third Circuit's decision is that a rescinding (perhaps swindled) seller who ultimately won his case for rescission in a subsequent year must pay a tax even though he merely restores himself to status quo, because, in all events, under the Third Circuit's decision, he must pay the tax in the year of sale. Moreover, the taxpayer will not even be entitled to any tax benefit in a later year when the sale is rescinded (Appendix B, *infra*, p. A13).

Thus, it tends to frustrate public policy by discouraging the pursuit of socially desirable remedies since a seller who successfully rescinds the sale will wind up without the proceeds but poorer for the tax. Indeed, it may make it impossible for such a seller to recover his property since after paying the tax for the year of sale he may not have enough money left to later restore to the buyer as would be required to consummate the rescission.

In conclusion, it must again be emphasized that the decision of the Court of Appeals in the Hope case is not mandated by any statute or case law precedent. Indeed, contrary to all precedent, it is the first case holding the taxpayer liable for tax on proceeds which he disclaims in good faith during the year of receipt. This conflict with established judicial precedent renders uncertain the tax laws to be applied under such circumstances. It is thus imperative for the proper administration of the Federal tax laws that this Court review the decision of the Third Circuit and render an authoritative determination.

VII. CONCLUSION.

For the reasons given above, it is respectfully submitted that this Court should grant the petition for a writ of certiorari to review the judgment of the Court of Appeals for the Third Circuit.

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DATED: May 10, 1973.

APPENDIX A.

Internal Revenue Code of 1954.

§ 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

(b) *Cross References.*—

For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following). Aug. 16, 1954, c. 736, 68A Stat. 17.

§ 451. General Rule for Taxable Year of Inclusion.

(a) *General Rule.*—The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

(b) *Special Rule in Case of Death.*—In the case of the death of a taxpayer whose taxable income is computed under an accrual method of accounting, any amount accrued only by reason of the death of the taxpayer shall not be included in computing taxable income for the period in which falls the date of the taxpayer's death. Aug. 16, 1954, c. 736, 68A Stat. 152; July 30, 1965, Pub. L. 89-97 Title III, § 313(b), 79 Stat. 382; Dec. 30, 1969, Pub. L. 91-172, Title II, § 215(a), 83 Stat. 573.

APPENDIX B.

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT.

No. 71-1993.

KARL AND HILDA HOPE,

Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

Nos. 71-1994/95.

KARL AND HILDA HOPE,

Appellants in No. 71-1994,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant in No. 71-1995.

ON APPEAL FROM THE UNITED STATES TAX COURT.

JULES I. WHITMAN, Philadelphia, Pa., *for Appellants in No. 71-1993/4 and Appellees in No. 71-1995;*

ELMER J. KELSEY, Washington, D. C., *for Appellant in No. 71-1995 and Appellees in No. 71-1993/4.*

Argued October 16, 1972.

Judges GIBBONS and ROSEN,* *Circuit Judges* and LAYTON, *District Judge.*

Opinion of the Court.

(Filed January 9, 1973)

GIBBONS, *Circuit Judge.*

The taxpayers, Karl and Hilda Hope, appeal from a decision of the United States Tax Court determining a deficiency in income tax for the taxable year 1960 in the amount of $985,459.00. The Commissioner has filed a protective appeal from the Tax Court decision determining an overpayment of $137,775.00 in the year 1961. Taxpayer has filed a cross appeal with respect to the year 1961.

The taxpayers have filed calendar year tax returns on the cash receipts and disbursements method of accounting. Prior to the years in issue Karl Hope was the sole stockholder of Perfect Photo, Inc. In 1959 a public offering of 150,000 shares of Perfect Photo stock was made at $14.00 a share. Of these shares 90,000 were sold by Karl Hope, and 60,000 by the Corporation. This left 210,000 shares in Hope's hands. He sold 3,600 shares in January, 1960, at $37.11 a share, and during 1960 he expressed an interest in selling his remaining 206,400 shares. At that time Perfect Photo employed Karl Hope's brother, Henry Hope, as a vice-president in charge of technical aspects of the business. It also employed Warren G. Grabb, a management engineer, and Henry J. Sentiff, a certified public accountant, both of whom were engaged in the company's financial affairs. The company stock was then traded on the American Stock Exchange.

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* Judge Rosen participated but died before the opinion was filed.

Sentiff approached Harriman Ripley and Company, Inc. of New York (Harriman Ripley), an underwriter of securities, about financing the purchase of Karl Hope's 206,400 shares. He then obtained from Karl Hope an agreement granting Sentiff and Grabb the right, for a period of thirty days from June 15, 1960, to purchase the 206,400 shares for $4,000,000.00. However, Sentiff was then advised by Harriman Ripley that Federal Reserve Board margin regulations, limiting loans for purchase of securities, would prevent its financing of the purchase by Sentiff and Grabb. As an alternative Harriman Ripley proposed that it purchase the 206,400 shares, at a price of $19.38 per share, for a total of $4,000,032.00, and that it give Sentiff and Grabb options until December 31, 1961, to purchase 75% of the acquired stock at the same price. Sentiff told Karl Hope that Harriman Ripley would purchase his stock, but at that time did not mention the options.

On June 25, 1960, the details of the purchase arrangement including the options to Sentiff and Grabb, were made known by Harriman Ripley to the attorney for Karl Hope, who was also general counsel, secretary, and a director of Perfect Photo. The attorney was informed that Karl Hope could not be included as an optionee without risking violation of the Federal Reserve Board margin regulations. A meeting then took place between Karl Hope, his brother Henry, Sentiff and Grabb, during which Karl Hope learned that Sentiff and Grabb were to benefit from the transaction by virtue of their options, and that he could not share in those benefits because of the margin regulations. At the meeting it was agreed that Henry Hope would be included as an optionee for 77,400 shares.

On July 15, 1960, Karl Hope, in the presence of his attorney, executed a contract to sell to Harriman Ripley, for its own account and as agent for other purchasers, 206,400 shares of Perfect Photo stock for $19.38 a share. Karl

Hope's obligation to complete the sale was conditioned upon the delivery by Harriman Ripley of options and proxies to Henry Hope for 77,400 shares, to Sentiff for 38,700 shares and to Grabb for 38,700 shares, all at $19.38 a share. Karl Hope attended the closing on July 27, 1960, with his attorney. All the conditions of sale having been met, including the delivery of the options and proxies to Henry Hope, Sentiff and Grabb, Karl Hope transferred 206,000 shares of Perfect Photo stock to Harriman Ripley and received checks totalling $4,000,032.00.

During June and July, 1960, Perfect Photo stock traded on the American Stock Exchange between a low of $40½ and a high of $66⅞ per share. In September, 1960, an article appeared in *Business Week* stating that Karl Hope had sold his Perfect Photo stock for $20 a share when it was trading at over $50 a share. He then became dissatisfied with the transaction, and consulted a new attorney. On that attorney's advice he maintained the proceeds of sale in liquid position, as cash in the bank $2,369,000.00, tax exempt municipal bonds $1,575,000.00, and marketable common stock, $429,000.00. On his behalf his attorney attempted unsuccessfully to negotiate a rescission of the sale. On December 21, 1960, Karl Hope filed a complaint in the United States District Court for the Eastern District of Pennsylvania against Harriman Ripley, Sentiff and Grabb, alleging a conspiracy to defraud him and seeking rescission. The complaint alleged that Henry Hope had acquiesced in a rescission and would perform such acts and execute any documents necessary to effectuate it.

The December 21, 1960 lawsuit resulted in a settlement on March 24, 1961, on these terms:

(1) Karl Hope paid $350,000.00 to Sentiff and Grabb in consideration of their assignment to him of their options to purchase a total of 77,400 shares of

Perfect Photo from Harriman Ripley. (Sentiff and Grabb had resigned as officers and directors of Perfect Photo on March 3, 1961.)

(2) Henry Hope assigned to Karl his option to purchase 77,400 shares of Perfect Photo without receiving any consideration.

(3) Henry Hope, Sentiff and Grabb returned the proxies for 154,800 shares of Perfect Photo stock to Harriman Ripley.

(4) Harriman Ripley confirmed to Karl Hope that the options assigned to him by Henry Hope, Sentiff and Grabb were valid and binding instruments, and delivered to Karl proxies to vote the 154,800 shares subject to the options.

(5) The lawsuit was dismissed with prejudice and without costs.

Thus on March 24, 1961, Karl Hope held options to repurchase 75% of the stock he had sold to Harriman Ripley on July 27, 1960, for the same price per share at which he had sold it. The options ran until December 31, 1961. During the week of the settlement, Perfect Photo stock traded at a low of $44⅞ and at a high of $48⅞. Hope's new attorney explored the possibility of a resale of the 154,800 shares at a lower price, but Harriman Ripley declined any discount off the option price. Karl Hope therefore concluded that he would hold the $3,000,024.00, the option price, until December. On December 18, 1961, he gave notice of the exercise of the options, and on December 29, 1961, in exchange for the agreed option price, received from Harriman Ripley the option stock.[1]

1. The stock had been split 3 for 1 on July 3, 1961. Thus Harriman Ripley delivered 464,400 shares.

During 1961 Karl Hope paid his new attorney $85,000.00 in counsel fees for conducting and settling the litigation against Sentiff, Grabb and Harriman Ripley and for effectuating the delivery of the option stock on December 29, 1961.

In his 1960 tax return Karl Hope disclosed the July 27, 1960 transfer of 206,400 shares of Perfect Photo stock for $4,001,632.00 ($19.38 per share, plus $1,600.00 stock transfer tax paid by Harriman Ripley). He did not, however, include any gain in income for 1960 on the theory that the transfer was not a completed sale on which gain was "recognized" in 1960. In his 1961 tax return Karl Hope reported a sale of 51,600 shares of Perfect Photo stock and showed net proceeds from that sale of $651,578.00. The net proceeds were computed by deducting from the $4,001,632.00 received in 1960 the $3,000,054.00 paid to Harriman Ripley on the exercise of the options on December 29, 1961, and the $350,000.00 paid to Sentiff and Grabb for assignment of their options on March 24, 1961. Thus only the 51,600 shares retained by Harriman Ripley were treated as having been sold, and that sale was treated as having taken place in 1961. In computing the gain on that sale Karl Hope used his original cost basis on the 51,600 shares, increased by the counsel fee of $85,000.00 paid in 1961.

In his notice of deficiency for 1960 the Commissioner determined that the petitioner realized a taxable gain in 1960 on the entire 206,400 shares transferred on July 27, 1960, amounting to $3,939,712.00; and assessed a deficiency of $985,459.00. In his notice of deficiency for 1961 the Commissioner determined, as an alternative to his determination with respect to 1960, that if the sale took place in 1961 petitioner had realized a taxable gain of $986,098.00 on the sale of 51,600 shares of Perfect Photo stock.

In 1962 there occurred a severe decline in the stock market. Following that decline, during 1962 and 1963,

Karl Hope sold a total of 464,340 of the option shares (154,780 shares prior to the stock split) for an average per share price of approximately $4.65 ($13.95 per share on a pre-stock split basis).[2]

In the Tax Court Karl Hope made these contentions:

1. That his tender of rescission in 1960 and an actual partial rescission in 1961 postponed the realization of gain on the sale of his stock until 1961.
2. That his tender of rescission should permit him to deduct in 1961, pursuant to Int. Rev. Code of 1954, § 1341, the amount included in his 1960 income under a claim of right because it was established after the close of the 1960 tax year that he did not have an unrestricted right to the proceeds of sale.
3. Alternatively, that there was an actual rescission in 1960 of a part of the transaction (Henry Hope's option for 77,400 shares) in 1960, and thus a sale of only 129,000 shares in 1960.
4. Alternatively, that he was induced by fraud to part with his stock in 1960, that this was an involuntary conversion within the meaning of Section 1033(a) of the Internal Revenue Code, that the repurchase of the shares from Harriman Ripley in 1961 was a repurchase of similar property, and that there was nonrecognition of gain under the Code to the extent of the repurchase. § 1033(a)(3)(A).

The Tax Court rejected each of these contentions. We affirm.

In advancing the argument that gain on the 1960 sale to Harriman Ripley was postponed to 1961, Karl Hope acknowledges the rule generally applicable to cash basis taxpayers:

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2. The resulting losses, unfortunately, could not be carried back to prior years. Int. Rev. Code of 1954, § 1212(b).

> "The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different year." Int. Rev. Code of 1954, § 451(a).

See Treas. Reg. § 1.451-1(a) (1957). The taxpayer here received the proceeds of sale on July 27, 1960, with no restriction as to its use or disposition. Under principles of annual accounting for tax purposes the gain resulting from a sale completed in 1960 was taxable in that year. *United States v. Lewis*, 340 U. S. 590 (1951); *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359 (1931).

Mr. Hope contends, however, that this generally applicable rule does not apply when in the year of the sale he files a suit for rescission and thus disclaims any right to the proceeds. He seeks to come within an exception to the claim of right doctrine, *North American Oil Consolidated v. Burnet*, 286 U. S. 417 (1932), that applies when in the year of receipt a taxpayer recognizes his liability under an existing and fixed obligation to repay the amount received and makes provision for such repayment. This should not be confused with his contention that he is entitled to tax treatment under the general or special rules with respect to taxpayers who have restored substantial amounts held under a claim of right. *See* Int. Rev. Code of 1954, § 1341. Rather, he first urges that in the circumstances under which he received the proceeds of sale the claim of right doctrine did not apply.

Most of the cases to which the taxpayer refers,[3] however, involve a taxpayer who in the year of receipt was

3. *Bates Motor Tranport Lines, Inc. v. Commissioner*, 200 F. 2d 20 (7th Cir. 1952), *aff'g* 17 T. C. 151 (1951) involved a contractual obligation of an accrual basis taxpayer to refund excessive freight tariffs, an acknowledgment of overpayments and a reserve

under a legal liability, which he acknowledged, to make repayment. But as the Tax Court found, Mr. Hope never was under any liability in 1960 to rescind the July 27, 1960 transaction. If, after that date, the market price of Perfect Photo stock had quickly declined below $20.00 a share he could, and undoubtedly would have elected to retain the proceeds of the sale. The contingent condition precedent to rescission—repayment of the purchase price—was entirely within his control, and imposed no restriction upon his use of the funds. In these circumstances his tender of rescission did not postpone realization of the gain. Even when the taxpayer's right to hold funds is disputed by others, if he has received those funds under a claim of right without restriction as to disposition the funds are income in the year of receipt although the taxpayer may later be adjudged liable to restore their equivalent. *Commissioner v. Brooklyn Union Gas Co.*, 62 F. 2d 505 (2d Cir. 1933) *aff'g.* 22 B. T. A. 507 (1931). Here, where both

3. (Cont'd.)

to that effect. *United States v. Merrill*, 211 F. 2d 297 (9th Cir. 1954) involved acknowledgment by an executor in the year of receipt of an obligation to repay excess executor's commissions to an estate. *Gaddy v. Commissioner*, 38 T. C. 943 (1962), *rev'd in part on other grounds*, 344 F. 2d 460 (5th Cir. 1965) involved a contractual obligation of a cash basis taxpayer to refund excessive freight tariffs, a firm renunciation by that taxpayer of any right to the excess payments and a contractual undertaking as to a method of repayment, all in the same year. *Sohio Corp. v. Commissioner*, 163 F. 2d 590 (D. C. Cir. 1947) *rev'g.* 7 T. C. 435 (1946) involved an accrual basis taxpayer forced against its will to collect and retain state taxes over its repeated protests, and whose protests ultimately resulted in refunds. We need not consider whether *Sohio* would have been decided as it was subsequent to the enactment, in the 1954 Code, of § 1341, for it is in any event quite unlike Mr. Hope's case. *Wilbur Buff v. Commissioner*, 58 T. C. 224 (1972) holds that an embezzler who acknowledges his liability for the embezzlement and in the same year allows a confession of judgment to be taken against him can thereby avoid the consequence that the embezzled funds are taxable to him in that year under *James v. United States*, 366 U. S. 213 (1961).

control over the funds and the decision as to seeking rescission are entirely within the taxpayer's control, is an *a fortiori* case.

Mr. Hope relies also on *Guffey v. United States*, 339 F. 2d 759 (9th Cir. 1964). Unlike the instant case, *Guffey* involved an installment contract for the sale of a residence. Title had not passed at the time, a year after the sale, when the purchasers discovered the house had dry rot and sued to rescind the contract. The parties settled out of court, with the buyers quitclaiming to the sellers and the sellers retaining the payments already made. In the same year as the settlement, the seller resold the house, and attempted to take bad debt and capital loss deductions for that year with respect to the original installment contract. The court held that the bad debt provisions of the Code were inapplicable since the non-payment was related to the physical condition of the house, not the financial condition of the first buyer. It held that there was no capital loss because neither the purchase of the house nor the first contract of sale was entered into for profit within the meaning of Int. Rev. Code of 1954, § 165(c)(2). Taxpayer contends that this case establishes the principle that a sale in one year and a rescission in another must for tax purposes be treated as a single transaction. It may be that for purposes of determining whether a capital asset has been held for business rather than for personal purposes it is appropriate to look at several transactions concerning sale of that asset in their entirety. But what is appropriate for determining the purpose for which a capital asset has been held is only remotely relevant to determining in what year a cash basis taxpayer has received the proceeds of a sale under a claim of right. The Tax Court did not find this authority supportive of Mr. Hope's position as to the taxability of the 1960 transaction, nor do we.

What we have said about taxpayer's first contention adequately disposes of his contention that he is entitled to the benefit of § 1341. That section, added to the Code in 1954, allows the deduction of an item in the year following its inclusion in income by virtue of the claim of right doctrine, when it is established after the close of the prior year that taxpayer did not in fact have an unrestricted right to the income in question. It has never been established that the taxpayer did not have an unrestricted right to receive the proceeds of sale. He was free to elect not to rescind. *See George L. Blanton,* 46 T. C. 527 (1966) *aff'd. per curiam* 379 F. 2d 558 (5th Cir. 1967). Even if we were to treat the March 24, 1961 settlement as establishing a restriction on taxpayer's right to hold the proceeds of sale, that settlement was a subsequent event brought about by him. In such circumstances § 1341 is inapplicable. Rev. Rul. 67-48, 1967-1 Cum. Bull. 50. Moreover even the settlement did not oblige Karl Hope to rescind the sale. It merely put in his hand, in exchange for $350,000.00, options to repurchase the stock he had sold.

The taxpayer's third contention, that at least a part of the transaction was actually rescinded in 1960, is equally untenable. If an actual rescission had taken place in 1960 it might well have been recognized for tax purposes. *See Penn v. Robertson,* 115 F. 2d 167 (4th Cir. 1940). The Tax Court found, however, that no actual rescission took place with respect to the 77,400 shares of stock in which Henry Hope held an option, either in 1960 or at any other time. The stipulated facts and testimony establish that the very most that was within the power of Henry Hope in 1960 was to assign to Karl Hope the option which the former held on the stock owned by Harriman Ripley. Even such an assignment was not made until March 24, 1961. Treating the assignment tendered in 1960 as actually completed, does not convert it into a rescission, for between the date

of the tender and December 29, 1961, when Karl Hope actually exercised the option, he remained free to decide to keep the proceeds of sale rather than seek return of the stock. There is simply no way to disregard the fact that on December 31, 1960, the taxpayer still held the entire proceeds of sale free of restrictions, and without liability for return.

There remains Mr. Hope's involuntary conversion contention. Here we need go no further than the factual determination of the Tax Court, amply supported in the record, that no fraud was practiced upon Karl Hope, and hence there is no basis for the application of Int. Rev. Code of 1954, § 1033.[4] The question whether the 1961 repurchase qualified under § 1033(a)(1) as a repurchase of similar property, need not be considered.[5]

The Tax Court ruled correctly that a sale took place in 1960 producing a taxable gain, that a repurchase took place in 1961, and that the $350,000.00 payment to Sentiff and Grabb and the $85,000.00 legal fees were capital expenses added to the cost basis of the shares repurchased in 1961.

The decision of the Tax Court will be affirmed. Each side shall bear its own costs.

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4. This factual determination disposes of Mr. Hope's contention, with respect to the 1961 tax year, that the $85,000.00 legal fee is deductible as a collateral theft loss under Int. Rev. Code of 1954, § 165(c)(3), and with the theory of constructive trust which he propounded.

5. In addition the Commissioner does not contend that the repurchased stock would not qualify as "similar or related" property for § 1033(a)(1) purposes.

IN THE
UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT.

Nos. 71-1993/1995.

KARL AND HILDA HOPE,
Appellants in Nos. 71-1993/71-1994,

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellant in No. 71-1995.

(Tax Court Docket Nos. 2258-65 and 3128-69)

ON APPEAL FROM A DECISION OF THE TAX COURT OF THE UNITED STATES.

Present: GIBBONS and ROSEN,* *Circuit Judges* and LAYTON, *District Judge.*

JUDGMENT.

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decision of the said Tax Court in this cause be, and the same is hereby affirmed. Each side shall bear its own costs.

ATTEST:

THOMAS P. PRICE,
Clerk.

January 9, 1973.

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* Judge Rosen participated but died before the opinion was filed.

IN THE

UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT.

No. 71-1993.

KARL AND HILDA HOPE,

Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

(Tax Court No. 2258-65)

Nos. 71-1994/95.

KARL AND HILDA HOPE,

Appellants in No. 71-1994,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant in No. 71-1995.

(Tax Court No. 3128-69)

SUR PETITION FOR REHEARING.

Present: SEITZ, *Chief Judge,* and VAN DUSEN, ALDISERT, ADAMS, GIBBONS, ROSENN, ROSEN,* and HUNTER, III, *Circuit Judges,* and LAYTON, III, *District Judge.*

The petition for rehearing filed by Karl and Hilda Hope Appellants in Nos. 71-1993 and 71-1994 and Appellees in No. 71-1995 in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

By the Court,

JOHN J. GIBBONS,
Judge.

Dated: February 14, 1973.

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* Judge Rosen participated but died before the opinion was filed.

APPENDIX C.

KARL HOPE AND HILDA HOPE

v.

COMMISSIONER.

Docket Nos. 2258-65, 3128-69. 55 TC 1020, No. 95.

Filed March 22, 1971.

Jules I. Whitman and Richard L. Levy, 2600 The Fidelity Bldg., Philadelphia, Pa., for the petitioners. Dennis C. DeBerry and Howard Gordon, for the respondent.

QUEALY, Judge: The respondent determined deficiencies in petitioners' income tax as follows:

Docket No.	*Taxable Year*	*Deficiency*
2258-65	1960	$991,127
3128-69	1961	$108,750

The deficiencies determined by the respondent in the instant case arose out of the purported sale by Mr. Karl Hope of 206,400 shares of stock of Perfect Photo, Inc. on July 27, 1960 and reflect the fact that the respondent took an inconsistent position with respect to the year of accountability for, as well as the amount of, the income realized on the sale.

The respondent conceded at trial that counsel's fees of $10,000 were deductible in 1960. The questions remaining for decision are:

(1) Whether the petitioner realized taxable gain in 1960 on account of the purported sale of 206,400 shares of stock of Perfect Photo, Inc.

(2) Whether third party optionees in substance purchased the petitioner's stock subject to a secured loan without recourse, *i.e.*, a mere pledge of the stock.

(3) Whether the petitioner's stock, as a result of its theft, was compulsorily or involuntarily converted.

(4) Whether it was established in a year subsequent to the sale that the petitioner did not have an unrestricted right to the sale proceeds.

(5) Whether counsel's fees and other costs were deductible in 1961.

FINDINGS OF FACT.

Some of the facts have been stipulated. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference. The facts necessary for our opinion are as follows:

Petitioners Karl and Hilda Hope are husband and wife. At the time of the filing of their petition, the petitioners resided in East Stroudsburg, Pennsylvania. For the taxable years here in question, calendar 1960 and 1961, the petitioners filed their joint income tax returns on the cash method of accounting with the district director of internal revenue, Philadelphia, Pennsylvania. Inasmuch as Hilda Hope is a petitioner solely as a result of the filing of a joint return, Karl Hope will hereinafter be referred to as the petitioner.

At all times material hereto, Perfect Photo, Inc. (hereinafter "Perfect Photo") was a corporation organized under Pennsylvania law and engaged in the business of developing and printing of photographic film. The petitioner purchased a one-half interest in Perfect Photo in 1946. At that time Perfect Photo was engaged in the photofinishing of black and white film. About 1952, the petitioner purchased the remaining 50 percent.

In 1959, Eastman Kodak released the processing of color film. This enabled Perfect Photo to go into the business of photofinishing color film. As a result, the volume of its business increased from several hundred thousand dollars to several million dollars per annum.

The petitioner and his brother, Henry Hope, were the principal officers and directors of Perfect Photo. The petitioner was involved in the financial and management aspects of Perfect Photo's business while Henry Hope confined his activities to the technical aspects of the business.

On or about June 1, 1959, Perfect Photo employed Warren G. Grabb (hereinafter "Grabb"), a management engineer, as a consulting engineer. In September 1959, Grabb became vice president and director of Perfect Photo. On or about August 1959, Perfect Photo employed Harry J. Sentiff (hereinafter "Sentiff"), a certified public accountant, as a vice president and director. Sentiff became engaged mainly in the financial affairs of Perfect Photo, and Grabb became engaged not only in the financial affairs but also in the management of Perfect Photo.

In October 1959, a public offering was made of the stock of Perfect Photo at $14 per share. A total of 150,000 shares of the stock of Perfect Photo was sold to the public, of which 60,000 shares were sold by Perfect Photo and 90,000 shares were sold by petitioner.

Following the public sale of the stock of Perfect Photo, the petitioner told Sentiff and Grabb, among others, that he wanted to dispose of the remainder of his stock, and the petitioner did sell 3,600 shares of that stock on January 12, 1960 at $37.11 per share. After the petitioner had made an unsuccessful attempt to merge Perfect Photo into another corporation and was otherwise unable to dispose of a large block of his stock, Sentiff discussed the situation with C. Clark Ambrose (hereinafter "Ambrose") of Harri-

man Ripley & Co., Inc. of New York, now doing business as Drexel, Harriman Ripley, Inc. (hereinafter "Harriman Ripley Co."). As a result of those discussions, a plan was worked out whereby Harriman Ripley Co. agreed to finance or participate in a purchase of the petitioner's stock interest in Perfect Photo which amounted to 206,400 shares, or approximately 57 percent, of the 360,000 issued and outstanding shares of Perfect Photo stock. However, Ambrose indicated that before Harriman Ripley Co. would proceed with any plan, Sentiff would have to produce written evidence of the petitioner's intention to sell his stock.

At Ambrose's suggestion, Sentiff obtained an agreement from the petitioner granting Sentiff and Grabb the right for a period of 30 days from June 15, 1960 to purchase all of the 206,400 shares of stock of Perfect Photo owned by the petitioner for the sum of $4,000,000 payable $10,000 upon written notice of exercise of the option on or before July 15, 1960 and the balance in cash on or before August 15, 1960.

On or about June 23, 1960, Ambrose advised Sentiff that Harriman Ripley Co. could not finance a purchase by Sentiff and Grabb because of Federal Reserve Board regulations limiting loans on securities. Ambrose proposed to Sentiff that Harriman Ripley Co. purchase the 206,400 shares of stock from the petitioner at a price of $19.38 per share for a total of $4,000,032 and give Sentiff and Grabb an option until December 31, 1961 to purchase 154,800 shares or 75 percent of the stock so acquired at the same price per share. Sentiff and Grabb also were to be given proxies to vote the 154,800 shares subject to the option.

Harriman Ripley Co. hoped to earn its profit from the 51,600 shares or 25 percent of the purchased stock that was not subject to the option. Sentiff and Grabb intended to

sell part of the option to investors or underwriters and to use the net proceeds of that sale to finance the purchase of the stock subject to the remaining part of the option.

Upon reaching this agreement with Harriman Ripley Co., Sentiff thereupon advised the petitioner that Harriman Ripley Co. would purchase his stock for $4,000,032. Sentiff did not tell the petitioner at that time that he and Grabb were going to receive an option to purchase 75 percent of the stock sold to Harriman Ripley Co.

However, on or about June 25, 1960, the details of the sale and option arrangement were made known to Mr. C. Laurence Cushmore, Jr. (hereinafter "Cushmore"), the attorney who represented the petitioner in the sale and was also the secretary of and a director of Perfect Photo and a partner in the law firm that was counsel for Perfect Photo. At that time, Sentiff told Cushmore that as the price of the Perfect Photo stock that was listed on the American Stock Exchange had increased substantially over the prior 10 days he and Grabb felt that some readjustment of the sale and option arrangement had to be made in fairness to the petitioner. However, when Cushmore received the first drafts of the documents of sale on July 8, 1960, he noticed that the option to purchase 75 percent of the stock ran from Harriman Ripley Co. to Sentiff and Grabb. When he asked Sentiff about this matter, he was told that the petitioner as the seller of stock could not be included as an optionee without the risk of violating the margin requirements applicable to listed securities under regulations issued by the Federal Reserve Board.

On or about July 11, 1960, Sentiff told Cushmore that Henry Hope would be included as an optionee with respect to 77,400 shares of the 206,400 shares of Perfect Photo stock that were to be sold by the petitioner to Harriman Ripley Co. This notification followed a meeting of the

petitioner, Henry Hope, Sentiff, and Grabb at which the petitioner was told that Sentiff and Grabb were to benefit from the transaction and that the petitioner could not share in those benefits because of government regulations. At that meeting it was also decided that Henry Hope would share any benefits with Sentiff and Grabb. The petitioner first became aware that Sentiff and Grabb were to be issued options to purchase 75 percent of the stock that was to be sold to Harriman Ripley Co. at this meeting which was held on or before July 10, 1960.

On July 14, 1960, stating that he understood that Henry Hope was to receive one-half of the benefits of the agreement under which the petitioner had granted Sentiff and Grabb the right for a period of 30 days from June 15, 1960 to purchase his 206,400 shares of Perfect Photo stock for $4,000,000 payable $10,000 on written notice of exercise on or before July 15, 1960 and the balance on or before August 15, 1960, the petitioner extended the time to July 25, 1960 for giving written notice and the payment of the $10,000.

Negotiations during June and July of 1960 between Cushmore, acting as counsel for the petitioner, counsel for Harriman Ripley Co., and separate counsel for Sentiff and Grabb culminated on July 15, 1960 in the execution of a purchase agreement between the petitioner and Harriman Ripley Co. as agent for several purchasers as well as for its own account. The petitioner agreed that at a closing date selected by Harriman Ripley Co. prior to August 15, 1960 he would sell his 206,400 shares of Perfect Photo stock at $19.38 per share with any transfer taxes payable by the purchasers. The petitioner's obligation to make the sale of his Perfect Photo stock was subject to the delivery by Harriman Ripley Co. of options to purchase 154,800 shares of Perfect Photo stock at $19.38 per share to Henry Hope, Sentiff, and Grabb in the respective amounts of 77,400, 38,700 and 38,700 shares.

The petitioner's obligation was further conditioned on the delivery by Harriman Ripley Co. of proxies to vote the optioned stock to the optionees. The proxies gave their holders the power to vote the stock solely for the election of directors of Perfect Photo. Although the reason for issuing the proxies was not given, the granting of the proxies to members of the management group was consistent with Harriman Ripley Co.'s opinion that Perfect Photo was in a service business that could best be run by that group.

Harriman Ripley Co.'s obligation to make the purchase was subject to the delivery by Perfect Photo of an agreement providing for the registration at Harriman Ripley Co.'s request of the purchased stock under the Securities Act of 1933. Harriman Ripley Co.'s obligation was further conditioned on the receipt of an opinion of their counsel that neither their purchase nor their delivery of options to Henry Hope, Sentiff, and Grabb would violate the Securities Act of 1933 or the Securities Exchange Act of 1934.

Harriman Ripley Co. selected July 27, 1960 as the closing date. Prior to the closing, Cushmore went over with the petitioner the terms of the purchase agreement of July 15, 1960 which was prepared by counsel for Harriman Ripley Co. Cushmore also attended the closing as the petitioner's counsel. At the closing, the conditions of sale were satisfied, and the petitioner transferred his 206,400 shares of Perfect Photo stock on receipt of several checks in the total amount of $4,000,032.

In satisfaction of its obligation under the purchase agreement, Harriman Ripley Co. executed and delivered at the closing options and proxies covering 77,400, 38,700 and 38,700 shares of the stock to Henry Hope, Sentiff, and Grabb, respectively. Although the petitioner initially did not know that Harriman Ripley Co. was going to issue options and proxies covering 75 percent of the stock, he re-

ceived notice of this fact prior to the sale and by extending his option to Sentiff and Grabb on July 14, 1960, indicated his consent to this arrangement.

At the time that Henry Hope received options and proxies covering 77,400 shares of the stock, he had an understanding with the petitioner that he would follow the petitioner's directions with respect to the options and vote the shares the way the petitioner wanted him to vote.

The options ran through December 31, 1961 but could be terminated by Harriman Ripley Co. prior to that date if the price of Perfect Photo stock on the American Stock Exchange fell below $30 for 5 consecutive business days or if Perfect Photo failed on request to file a registration statement with respect to the stock purchased from the petitioner or use its best efforts to cause such statement to become effective at the earliest possible date.

The proxies were irrevocable until December 31, 1961 unless the options were transferred or terminated or if Perfect Photo without the consent of Harriman Ripley Co. issued additional equity interests other than for certain defined purposes.

At the insistence of the petitioner, Henry Hope, Sentiff, and Grabb entered into an agreement, dated July 27, 1960, which provided that neither the options nor the stock acquired by the exercise of the options would be transferred or disposed of in excess of 100 shares during any calendar week without notice to the other parties and an opportunity for the other parties to participate in the disposition. The petitioner's purpose in requiring this agreement was to insure against one of the three optionees selling an interest that might be significant enough to lessen the market value of the interests held by the other optionees.

As the petitioner was selling his stock interest in Perfect Photo, it was requested that he and his brother, Henry Hope, be given employment agreements. At some

point during July 1960, the petitioner and Henry Hope received employment contracts.

During June and July 1960, Perfect Photo stock traded at a low of $40½ per share and a high of $66⅞ per share on the American Stock Exchange.

In September 1960, an article appeared in *Business Week* which stated that the petitioner had sold his stock at $20 a share at a time when Perfect Photo stock was trading over $50. Following this article, the petitioner became dissatisfied with the transaction.

As a result of that dissatisfaction, the petitioner shortly thereafter consulted Harold E. Kohn (hereinafter "Kohn") of the law firm of Dilworth, Paxson, Kalish, Kohn & Dilks. It was Kohn's opinion that the petitioner had an excellent prospect of recovery if he sued for a rescission. The petitioner told Kohn to first attempt to recover the stock by negotiation. On Kohn's advice, the petitioner held the sale proceeds in cash and marketable securities pending the settlement of the dispute.

On December 15, 1960, Sentiff and Grabb refused to give up their options, and Harriman Ripley Co. refused to return the Perfect Photo stock that it had purchased from the petitioner. Henry Hope readily agreed to transfer the options issued in his name to the petitioner at any time upon the latter's request.

Approximately 5 months after the sale, on December 21, 1960, the petitioner, on advice of counsel, filed a complaint in the United States District Court for the Eastern District of Pennsylvania naming as defendants Harriman Ripley Co., Sentiff and Grabb. The complaint alleged, in part, that:

> * * * in or about January, 1960, defendants Sentiff and Grabb, pursuant to a conspiracy between them to defraud plaintiff, and in abuse and violation of their con-

> fidential and fiduciary duties to plaintiff, commenced efforts to induce him to sell the remaining 206,400 shares of stock of Perfect [Photo] owned by him, at a price substantially below the market price and the actual and fair value of said shares, concealing from him their intention to acquire the same for themselves.

It was also alleged that Sentiff and Grabb knew that the petitioner could have obtained a sales price in excess of $8,000,000 for those shares.

After a statement of the grounds relied upon, the complaint, in part, requested:

> 1. That defendants and each of them be ordered and required to rescind the transactions complained of, to return to plaintiff the aforesaid 206,400 shares of stock of Perfect [Photo], of which he has been defrauded, and to execute such documents as may be necessary to effectuate such rescission of record, upon repayment of the aforesaid sum of $4,000,000, together with the net earnings thereon.

Other than a prayer for punitive damages together with costs and reasonable counsel fees, the sole relief sought was for rescission and matters ancillary thereof.

The complaint further stated that Henry Hope, who was not named as a defendant, had informed the petitioner that he acquiesced in the rescission and would perform such acts and execute such documents necessary to effectuate a rescission. On March 24, 1961, Henry Hope did, in fact, assign to the petitioner the option to purchase 77,400 shares of Perfect Photo stock Harriman Ripley Co.

Settlement negotiations between the parties to the suit culminated in the filing with the court on March 24, 1961 of a stipulation of dismissal in which counsel for the parties

stipulated and agreed that the petitioner's action "be dismissed with prejudice as to all defendants named in the Complaint, without cost to any party." The basis of settlement was as follows:

(a) Sentiff and Grabb received $350,000 from the petitioner in consideration of their assignment to him of their options to purchase 77,400 shares of Perfect Photo stock from Harriman Ripley Co.;

(b) Sentiff and Grabb returned to Harriman Ripley Co. their proxies to vote the shares subject to the options that they assigned to the petitioner;

(c) Harriman Ripley Co. waived the requirement in the option agreement that an optionee give Harriman Ripley Co. at least 5 days' written notice of a transfer;

(d) Harriman Ripley Co. confirmed that to the best of its knowledge the options assigned to the petitioner by Henry Hope, Sentiff and Grabb were valid and binding instruments and delivered to the petitioner proxies to vote the 154,800 shares of Perfect Photo stock that were the subject of the options assigned to the petitioner; and

(e) As Henry Hope, Sentiff, and Grabb no longer held options to purchase Perfect Photo stock, they rescinded, terminated, and cancelled their agreement which provided that neither the options nor the stock acquired by the exercise of the options would be transferred or disposed of in excess of 100 shares during any calendar week without notice to the other parties and an opportunity for the other parties to participate in the disposition.

During the week which included March 24, 1961, Perfect Photo stock traded at a low of $44⅝ per share and a high of $48⅞ per share.

Shortly after the petitioner filed his complaint in the United States District Court, the United States Securities and Exchange Commission requested that it be apprised of developments and the Pennsylvania Securities Commission after an investigation ordered a hearing before the full Commission. The hearing before the Pennsylvania Securities Commission was held on April 19, 1961. At that hearing the Commission was informed that the litigation brought by the petitioner had been settled.

On May 4, 1961, the Pennsylvania Securities Commission sent letters to Harriman Ripley Co., Sentiff, and Grabb which contained the following statements with regard to their investigation of the sale:

> This is to advise you that the Commission, upon its investigation and consideration of the evidence presented before it in reference to the aforesaid matter, has concluded that you have engaged in activities in violation of The Pennsylvania Securities Act which would justify, among other things, the entry of an order of rescission by it against you.
>
> However, in view of the fact that a settlement has been made, satisfactory to all parties, which, in the opinion of the Commission would be equivalent in effect to compliance with an order of rescission, the Commission has determined to waive the entry of any formal order and is accordingly marking this case closed.

The letters cautioned against any recurrence of "the type of practices revealed in this matter" and the letters addressed to Sentiff and Grabb also cautioned against their engaging in the sale of securities without registering as a dealer or salesman.

The petitioner had until December 31, 1961 to exercise his options to acquire the 154,800 shares of Perfect Photo

stock held by the Harriman Ripley Co. Although the petitioner discussed the possibility of an early exercise of his options, he decided to wait until the end of the option period, as the Harriman Ripley Co. would not accept an option price of less than the agreed price.

After a request by the petitioner's counsel to extend the termination date of the options was denied, the petitioner delivered written notice to the Harriman Ripley Co. on December 18, 1961 of his intention to exercise his options on December 29, 1961. On December 29, 1961, in order to reflect a 3 for 1 split of Perfect Photo stock that occurred on July 3, 1961, the Harriman Ripley Co. delivered certificates evidencing 464,400 shares of Perfect Photo stock to the petitioner in consideration of the receipt of the agreed option price of $3,000,024. In 1962 and 1963, the petitioner sold a total of 464,340 of those shares at an average per share price of approximately $4.65.

The petitioner paid Dilworth, Paxson, Kalish, Kohn & Dilks counsel's fees of $85,000 in 1961 for conducting and settling the litigation involving Sentiff, Grabb, and the Harriman Ripley Co. and for effecting the delivery of the 464,400 shares of Perfect Photo stock from the Harriman Ripley Co.

In his 1960 tax return, the petitioner disclosed the transfer of 206,400 shares of Perfect Photo stock for $4,001,632 ($19.38 per share, plus $1,600 stock transfer tax paid by the Harriman Ripley Co.). However, the petitioner did not include in income his gain on the sale on the grounds that the transfer was not a completed sale on which gain was "recognized" in 1960. In his notice of deficiency, dated February 15, 1965, the respondent determined that the petitioner realized in 1960 a taxable gain of $3,939,712 on the sale of 206,400 shares of Perfect Photo stock to Harriman Ripley Co.

In his 1961 tax return, the petitioner reported $4,001,632 as proceeds from the sale, reduced the proceeds by the $3,000,054[1] paid to Harriman Ripley Co. on the exercise of the options and by the $350,000 paid to Sentiff and Grabb, and reported $651,578 as net proceeds from "shares deemed sold." In computing his gain, the petitioner used his original cost basis in the 51,600 shares of Perfect Photo stock that were not subject to the option increased by counsel's fees of $85,000. In his notice of deficiency, dated April 24, 1969, the respondent determined in the alternative to his prior determination of February 15, 1965 that the petitioner realized in 1961 a taxable gain of $986,098 on the sale of 51,600 shares of Perfect Photo stock.

Opinion.

1. The Petitioner's Suit for Rescission Did Not Postpone the Realization of Taxable Gain on the Completed Sale.

The facts of this case conclusively establish that on July 27, 1960 the petitioner sold 206,400 shares of Perfect Photo stock to Harriman Ripley Co. as agent for several purchasers as well as for its own account. The sale was completed on that date when title and possession of the certificates were transferred by the petitioner to Harriman Ripley Co., and the petitioner received $4,000,032 as payment in full. For the purposes of determining when the contract of sale was executed, it is immaterial whether Harriman Ripley Co., the ostensible purchaser, was acting on its own and its disclosed principals' behalf or on the behalf of others. The petitioner received the money from the sale without any restrictions on his use or disposition of those funds.

Some months after the sale of the stock but within the same taxable year, the petitioner became dissatisfied. This

1. The correct figure was $3,000,024.

dissatisfaction cannot be attributed to the supposed discovery that Sentiff and Grabb might stand to benefit from the transaction. The petitioner knew this prior to the sale, and the specific benefits that Sentiff and Grabb were to receive were clearly spelled out in the sales agreement which the petitioner examined in the presence of his attorney. The petitioner's dissatisfaction cannot be attributed to the issuance of an option to purchase 77,400 shares of stock to his brother, Henry Hope, as the petitioner knew of and consented to that arrangement. Thus, it is clear that the petitioner's dissatisfaction resulted solely from the fact that he felt that the price of the stock that he had sold had been inadequate.

As a result of his dissatisfaction, the petitioner consulted Dilworth, Paxson, Kalish, Kohn & Dilks, who advised the petitioner that there were grounds for a suit to rescind the sale. After unsuccessfully attempting to reach a settlement with the purchaser, the petitioner filed such suit on December 21, 1960 naming as defendants Harriman Ripley Co., Sentiff, and Grabb. That suit was pending at the close of 1960.

With respect to taxpayers who file their returns on the cash receipts and disbursements method of accounting, section 451(a)[2] provides that income shall be included in the return "for the taxable year in which received by the taxpayer * * *." *Boyce v. United States* [69-1 USTC ¶9124], 405 F. 2d 526 (Ct. Cl. 1968). Although the petitioner does not question the general rule that a cash basis taxpayer must return income from a completed sale in the taxable year in which he receives the sale proceeds (sections 61(a)(3); 451(a); 1.451-1(a), Income Tax Regs.), he contends that his complaint requesting a rescission of the sale postponed his obligation to return the income from the sale

2. All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

until the year in which the suit was settled. We are unable to agree.

The petitioner parted with his stock and received $4,000,032. The fact that the petitioner voluntarily held the sale proceeds in cash and marketable securities was not such a use of the funds as would change the character of the proceeds as income.

The petitioner relying on *Bates Motor Trans. Lines v. Commissioner* [52-2 USTC ¶9564], 200 F. 2d 20 (C. A. 7, 1952), affirming [Dec. 18,454] 17 T. C. 151 (1951); *United States v. Merrill* [54-1 USTC ¶9275], 211 F. 2d 297 (C. A. 9, 1954); *J. W. Gaddy* [Dec. 25,673], 38 T. C. 943 (1962), reversed in part on other issues [65-1 USTC ¶9342], 344 F. 2d 460 (C. A. 5, 1965), contends that the gain derived in the 1960 sale must be eliminated from that accounting period, as he disclaimed his rights to the sale proceeds in the year of receipt.

The cases relied on by the petitioner establish an exception to the claim of right doctrine that applies when in the year of receipt a taxpayer recognizes his liability under an existing and fixed obligation to repay the amount received and makes provisions for repayment. *J. W. Gaddy, supra.* This exception cannot be applied in the instant case, as the petitioner was never under an existing and fixed obligation to repay the sale proceeds.

The petitioner's contingent liability to pay back an amount equivalent to the proceeds received on the sale if his suit for rescission was successful imposed no restriction upon his use of the money in his hands. *Commissioner v. Brooklyn Union Gas Co.* [3 USTC ¶1033], 62 F. 2d 505 (C. A. 2, 1933), affirming [Dec. 6760] 22 B. T. A. 507 (1931). *Harry F. Doyle* [Dec. 10,700], 39 B. T. A. 940 (1939), affd. [40-1 USTC ¶9287] 110 F. 2d 157 (C. A. 2, 1940); *Guffey v. United States* [65-1 USTC ¶9144], 339 F. 2d 759 (C. A. 9, 1964); and *Sohio Corporation v. Commissioner*

[47-2 USTC ¶ 9338], 163 F. 2d 590 (C. A. D. C. 1947), reversing [Dec. 15,299] 7 T. C. 435 (1946), are distinguishable. *Harry F. Doyle, supra,* and *Gaffey v. United States, supra,* involved executory contracts.

Sohio Corporation v. Commissioner, supra, involved the exclusion from gross income of amounts which an accrual basis taxpayer at no time asserted a right to retain but which the taxpayer was compelled by state law, over its formal and repeated protests, to collect. Furthermore, the holding that an accrual basis taxpayer does not derive income with respect to an amount actually received and not subject in the year of receipt to an offsetting obligation to refund is in our opinion incorrect.

Assuming that when he requested the rescission he chose to limit himself to that remedy, and regardless of whether there might have been probable cause, the mere filing of the suit by the petitioner was not of itself sufficient to postpone the realization of gain on the completed sale. *Commissioner v. Brooklyn Union Gas Co., supra.* Under the long established principle of annual accounting for tax purposes, the gain resulting from the sale was taxable in 1960. *United States v. Lewis* [51-1 USTC ¶ 9211], 340 U. S. 590 (1951); *Burnet v. Sanford & Brooks Co.* [2 USTC ¶ 636], 282 U. S. 359 (1931); *Commissioner v. Brooklyn Union Gas Co., supra.*

2. *Settlement of the Petitioner's Suit Did Not Result in a Rescission of the Original Sale.*

The petitioner contends that his receipt in March 1961 of the options and proxies issued with respect to the 154,800 shares of Perfect Photo stock, or alternatively his receipt in December 1961 of the stock itself, was tantamount to a rescission that limited his gain on the sale to that derived from the 51,600 shares retained by Harriman Ripley Co.

This Court is not faced with the situation where the sale is rescinded in the same year. Compare *Penn v.*

Robertson [40-2 USTC ¶ 9707], 115 F. 2d 167 (C. A. 4, 1940). In fact, it is not necessary to decide what might have been the result if the sale had been rescinded in the following year. Compare *Penn v. Robertson, supra,* with *Ripley Realty Co.* [Dec. 7120], 23 B. T. A. 1247 (1931), affirmed per curiam 61 F. 2d 1038 (C. A. 2, 1932). It is clear that the settlement of the suit filed by the petitioner was not tantamount to a rescission at any time.

With respect to the optioned stock, the petitioner contends that Sentiff, Grabb, and Henry Hope were the real purchasers of the stock with Harriman Ripley Co. merely acting as a lender of funds for which it received 51,600 shares of the stock. Assuming that the facts establish this to be the substance of the 1960 sale, the petitioner next contends that he and the actual purchasers rescinded the sale in 1961. While we agree with the petitioner's observation that the substance of a transaction must prevail over its form (*Commissioner v. Court Holding Co.* [45-1 USTC ¶ 9215], 324 U. S. 331 (1945)), and that the rule may work for the benefit of the taxpayer as well as the government (*Frank Ciaio* [Dec. 28,326], 47 T. C. 447 (1967); *Maynard Hospital, Inc.* [Dec. 29,751], 52 T. C. 1006 (1969)), we do not find that the realities of the transactions that are the subject of the instant case differ from the form in which they were cast.

There is no doubt that Sentiff and Grabb were interested in purchasing a part of the stock and that Harriman Ripley Co. issued them the options to accomplish their goal. It also appears that Henry Hope was included as an optionee as an additional inducement for the petitioner to complete the sale, which inducement can be reasonably traced to the sharp increase that occurred during the negotiations in the price of the Perfect Photo stock that was listed on the American Stock Exchange. While the transaction might have the same attributes as a nonrecourse loan

by Harriman Ripley Co. to the optionees, it does not follow that, as to petitioner, the sale should be set aside.

At no time did Sentiff, Grabb, or Henry Hope agree to purchase stock from the petitioner or become indebted to Harriman Ripley Co. on account of the 1960 sale. At all times after the sale and until the petitioner exercised the options, title to the stock subject to the options held by Sentiff, Grabb, and Henry Hope, as well as risk of loss with respect to that stock rested with Harriman Ripley Co. Sentiff, Grabb, and Henry Hope were not the owners of that stock. An option is not considered a present interest in stock. See *Winthrop M. Crane III* [Dec. 27,830], 45 T. C. 397 (1966); *Max H. Wyman* [Dec. 24,000], 33 T. C. 622 (1959).

Sentiff, Grabb, and Henry Hope were given the right to vote the shares subject to their options for the election of directors. However, this right cannot be considered as placing ownership of the stock in them. Harriman Ripley Co. granted that right as it, as the owner of the stock, believed that the current management should be allowed to continue to operate the business. By giving Sentiff, Grabb, and Henry Hope, who agreed to vote his proxies as directed by the petitioner, control over the board, which included directors other than themselves, the management of the business was placed squarely in their hands.

The petitioner's reliance on *Union Planters Nat. Bank of Memphis v. United States* [70-1 USTC ¶ 9372], 426 F. 2d 115 (C. A. 6, 1970), and *American National Bank of Austin v. United States* [70-1 USTC ¶ 9184], 421 F. 2d 442 (C. A. 5, 1970), is misplaced. It is true that Harriman Ripley Co. could terminate the options if the stock fell below $30 and attempt to market the stock at a price in excess of its cost. However, this was in no way comparable to the understandings in the *Union Planters Nat. Bank of Memphis* and *American National Bank of Austin* cases that the basic risk of ownership of securities remain with the "sellers."

Once we recognize that Harriman Ripley Co., rather than the optionees, was the actual purchaser of the stock, it cannot be argued that there was ever a rescission of the original sales contract. The seller paid $350,000 to Sentiff and Grabb, the perpetrators of the alleged fraud and received from them and his brother, Henry Hope, the assignment of their respective rights under an option to purchase three-fourths of the stock from Harriman Ripley Co. That firm's ownership of the stock was unaffected by the agreement entered into as a result of the suit for rescission. Harriman Ripley Co. gave up nothing. When Harriman Ripley Co. transferred the optioned stock to the petitioner in 1961, it was pursuant to the original sales agreement.

Once the petitioner obtained the options, he had an election either to buy back the stock or to keep the money and allow the transaction to stand. This was a valuable right for which the petitioner was "out of pocket" by the sum of $350,000. In recognition of the value of this right, the petitioner sought a discount for giving it up. Later his counsel sought to obtain additional time within which to make a decision as to the exercise of the options. It is obvious that if the precipitous decline in the market price of the stock had occurred prior to the date on which the petitioner had to exercise the option, the petitioner would not have repurchased the stock and would not be before this Court. This element of choice cannot be reconciled with the petitioner's claim that the sale was rescinded.

It is clear that the settlement which resulted in the reacquisition of 154,800 shares of the stock was a new transaction that had no effect upon the petitioner's tax liability for 1960. *Ripley Realty Co., supra.*

As we are concerned with whether gain realized in a prior year may be limited by the events of a subsequent year, rather than with the characterization of amounts re-

ceived in the year of settlement of litigation, *Margery K. Megargel* [Dec. 13,729], 3 T. C. 238 1944), and *Albert J. Goldsmith* [Dec. 20,537], 22 T. C. 1137 (1954), relied on by the petitioner are inapplicable.

If an inequity exists, it is the inability of the petitioner to carry back his 1962 and 1963 losses and apply those losses against his 1960 gain, a result that can be changed only by the Congress.

3. The Petitioner's Stock Was Not Compulsorily or Involuntarily Converted.

The petitioner contends that he was induced to sell his stock by fraud and false pretenses such as constitutes theft within the meaning of section 1033(a) and that by exercising the options he acquired property similar or related in service or use to the property converted so as to cause the nonrecognition of gain from the sale to the extent of his reinvestment. Specifically the petitioner alleges that Sentiff and Grabb made false representations as to the adequacy of the sales price and thus that the sale involved the criminal appropriation of his stock in violation of both Pennsylvania law ("Cheating by fraudulent pretenses," Pa. Stat. Ann. tit. 18, sec. 4836 (1963); "Conspiracy to do unlawful act," Pa. Pa. Stat. Ann. tit. 18, sec. 4302 (1963)) and Federal law (Mail Fraud, 18 U. S. C. A. sec. 1341).

The term theft as used in the Internal Revenue Code is a word of general and broad connotation intended to cover and covering any criminal appropriation of another's property to the use of the taker, particularly including theft by swindling, false pretenses, and any other form of guile. *Edwards v. Bromberg*, [56-1 USTC ¶9448], 232 F. 2d 107 (C. A. 5, 1956); *Perry A. Nichols* [Dec. 27,293], 43 T. C. 842 (1965); and *Robert S. Gerstell* [Dec. 27,937], 46 T. C. 161 (1966).

It has been held by the courts of Pennsylvania that a criminal false pretense is "the false representation of an existing fact, whether by oral or written words or conduct, which is calculated to deceive, intended to deceive, and does, in fact, deceive, and by means of which one person obtains value from another without compensation." *Commonwealth v. Evans*, 190 Pa. Super. 179, 154 A. 2d 57 (1959), affirmed per curiam 160 A. 2d 407 (1960).

This is not a case where there has been a prior adjudication or admission of fraud. On the contrary the suit filed by the petitioner was contested. The Pennsylvania Securities Commission stated that in their opinion Sentiff, Grabb, and Harriman Ripley Co. had engaged in activities in violation of the Pennsylvania Securities Act which would justify the entry of an order of rescission of the sale. However, the nature of the violations of the Act was not stated, and the Commission did not indicate that Sentiff, Grabb, or the Harriman Ripley Co. engaged in fraudulent practices even though the Act specifically dealt with such practices. See Pa. Stat. Ann. tit. 70, sec. 52 (1963).

The petitioner clearly wanted to sell his stock. Whether the price paid, namely $4,000,000, was adequate involved a question of judgment. Certainly the petitioner was best qualified to make that judgment. He had already made several efforts to sell the company or to merge with another company. He had sold some of his stock. He had acquired similar businesses. Better than anyone else he certainly knew what the future risks and prospects might entail.

The market quotation with respect to the shares that were traded on the American Stock Exchange would not necessarily be determinative of value of the shares sold to Harriman Ripley Co. Admittedly the petitioner's 206,400 shares could not have been sold on the American Stock Exchange without driving down the price. Once it became

known that the petitioner was "selling out," the result could be disastrous.

On the other hand, if offered privately as a block carrying with it control of Perfect Photo, the stock would be valued on a different basis. One buyer might be willing to pay more for control. Another less, if the stock had to be fed into the market, to take into account the fact that the seller was the principal executive officer upon whom Perfect Photo largely depended for its success.

In short, the position of both parties to the sales negates a finding that the price was not "right." The petitioner certainly must be assumed to have had a better knowledge with respect to the business and its future potential than any outsider. Harriman Ripley Co. was experienced in this type of transaction and must have known what was being sold. We are thus unable to conclude that the consideration was so inadequate as to impute fraud.

The petitioner also knew that Sentiff and Grabb stood to benefit from the transaction. There was no concealment at the time of sale. The appropriate occasion for the petitioner to complain was when he first learned that Sentiff and Grabb were to participate in the benefits of the sale.

The petitioner states on brief that his suit for rescission contained all the allegations essential to establish the Federal crime of mail fraud. Without attempting to adjudicate the scope of that complaint, it is sufficient to state that there is not a scintilla of evidence of an intent to defraud within the meaning of that statute. Also, the record is devoid of evidence of a conspiracy to do an unlawful act.

4. The Petitioner Was Never Obligated to Return Any Portion of the Sale Proceeds to Harriman Ripley Co.

The petitioner contends that his 1961 tax liability can be computed taking into account section 1341. The availability of that section is conditioned on the petitioner's

showing that a deduction was allowable for 1961 "because it was established after the close of • • • [1960] that the taxpayer did not have an unrestricted right to • • • [the proceeds of the 1960 sale]."

The facts of the instant case do not satisfy that condition as under the terms and conditions of the 1960 sale the petitioner was never obligated to return any portion of the sale proceeds to Harriman Ripley Co. See *George L. Blanton* [Dec. 28,054], 46 T. C. 527 (1966), affirmed per curiam [67-2 USTC ¶ 9561] 379 F. 2d 558 (C. A. 5, 1967). In addition, the petitioner has not shown any payment to Harriman Ripley Co. that was deductible.

5. There Is No Basis for Finding That the Petitioner Incurred a Loss on Account of Theft or Fraud.

The petitioner contends that the $85,000 counsel's fees paid in attempting to effect a recovery of his property are deductible as a theft loss under section 165(c)(3). If the petitioner's stock had been appropriated by false pretenses, counsel's fees incurred in connection with that theft might have been deductible as additional or collateral theft losses. See: *Katherine Ander* [Dec. 28,370], 47 T. C. 592 (1967). However, we have been unable to find that the sale involved a criminal appropriation and thus the counsel's fees are not deductible under section 165(c)(3).

This leaves the question of whether the counsel's fees are deductible under sections 212 or 162 as ordinary and necessary expenses relating to the petitioner's sale as an investor and controlling stockholder of Perfect Photo or as the principal officer of that firm.

The counsel's fees were for conducting and settling the litigation involving Sentiff, Grabb, and Harriman Ripley Co. and for effecting delivery of the 464,400 shares of Perfect Photo stock from Harriman Ripley Co. To the

extent that these fees were attributable to the litigation, they were capital expenditures since they were costs incurred in the petitioner's attempt to reacquire a capital asset. *Spangler v. Commissioner* [63-2 USTC ¶9777], 323 F. 2d 913 (C. A. 9, 1963), affirming a Memorandum Opinion of this Court [Dec. 25,186(M)]; *Munson v. McGinnes* [60-2 USTC ¶9508], 283 F. 2d 333 (C. A. 3, 1960). The fact that the suit was unsuccessful in that Harriman Ripley Co. did not return the stock for the sale proceeds does not render the fees ordinary and necessary expenses rather than capital expenditures. *Radio Station WBIR, Inc.* [Dec. 23,416], 31 T. C. 803 (1959); *Stass Reed* [Dec. 30,370], 55 T. C. 32 (1970). To the extent that the fees were attributable to the delivery of stock, they were also capital expenditures. *Stephens Fuel Co., Inc.* [Dec. 4385], 13 B. T. A. 666 (1928).

As the firm's principal officer, it must be assumed that the petitioner was also interested in recovering control of Perfect Photo. However, the litigation involved in essence whether he had grounds to reacquire the stock which embodied that as well as other rights. Also, even if it were determined that the voting rights should bear some of the expense, an allocation could not be made on the basis of this record.

The $350,000 paid to acquire the option was a cost of the option and not a deductible expense. *Stires Corporation* [Dec. 8042], 28 B. T. A. 1 (1933).

Accordingly, the respondent properly allocated these payments to the stock acquired by the petitioner on his exercise of the options.

Reviewed by the Court.

Decisions will be entered under Rule 50.

In the Supreme Court of the United Sta

OCTOBER TERM, 1972

No. 72-1539

KARL AND HILDA HOPE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. A18-A42) are reported at 55 T.C. 1020. The opinion of the court of appeals (Pet. App. A3-A14) is reported at 471 F. 2d 738.

JURISDICTION

The judgment of the court of appeals was entered on January 9, 1973, and a petition for rehearing by Karl and Hilda Hope was denied on February 14, 1973 (Pet. App. A15-A17). The petition for a writ of certiorari was filed on May 15, 1973. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether both courts below correctly held that petitioner's[1] sale of his shares of stock in Perfect Photo, Inc. was final in 1960, notwithstanding his unsuccessful attempt to rescind the sale in that year, and that the gain realized thereon was thus includible in his 1960 return.

STATUTES INVOLVED

The pertinent statutes are set forth in the Appendix to the petition (pp. A1-A2).

STATEMENT

Petitioner in 1960 sold his controlling interest (206,400 shares) in a corporation known as Perfect Photo, Inc. to Harriman Ripley and Company, Inc. In accordance with the conditions of the sale, Harriman Ripley, in turn, delivered an option to purchase 77,400 shares to petitioner's brother, Henry, and options to purchase 38,700 shares each to Sentiff and Grabb, employees of the corporation, all at the price sold by petitioner (Pet. App. A4-A6).

Petitioner became dissatisfied with the sale, and after unsuccessfully attempting to negotiate a rescission, instituted a suit on December 21, 1960, in the United States District Court for the Eastern District of Pennsylvania to rescind the sale of his stock. He alleged that Harriman Ripley, Sentiff and Grabb had conspired to defraud him (Pet. App. A6). The suit was settled on March 24, 1961. Under the terms of the settlement, petitioner paid $350,000.00 to Sentiff and Grabb as

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[1] "Petitioner" refers to Karl Hope. Hilda Hope is a party to this proceeding solely as the result of filing joint returns.

consideration for the assignment to him of their options to purchase a total of 77,400 shares of Perfect Photo from Harriman Ripley, and Henry Hope assigned to petitioner his option to purchase 77,400 shares of Perfect Photo without receiving any consideration. Consequently, on March 24, 1961, petitioner held options (which ran until December 31, 1961) to repurchase 75% of the stock he had sold to Harriman Ripley at the same price per share at which he had sold it. On December 29, 1961, he exercised the options, receiving the option stock in return for the agreed option price (Pet. App. A6-A7).[2]

Petitioner paid his attorney $85,000.00 in counsel fees for handling and settling the rescission suit and for effecting the delivery of the option stock (Pet. App. A8).

On his 1960 tax return, petitioner disclosed the July 27, 1960 transfer of 206,400 shares of Perfect Photo for $4,001,632, but he did not report any gain in that year from the sale on the ground that the transfer was not a completed sale in 1960. Instead, on his 1961 return, the 51,600 shares[3] of Perfect Photo retained by Harriman Ripley were treated as having been sold in that year and petitioner reported net proceeds from this sale of $651,578.00. The net proceeds figure was computed by reducing the $4,001,632.00 received in 1960 by (1) the $3,000,054.00 paid to Harriman Ripley

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[2] Following a sharp decline in the stock market in 1962, petitioner sold virtually all of the option stock during 1962 and 1963, suffering substantial losses on such sales. The resulting losses could not be carried back to prior years. Section 1212(b), Internal Revenue Code of 1954 (Pet. App. A8-A9).

[3] This figure reflects the difference between the 206,400 shares originally sold to Harriman Ripley in 1960 and the 154,800 shares repurchased by petitioner in 1961.

in December of 1961 on the exercise of the options and (2) the $350,000.00 paid to Sentiff and Grabb for the assignment of their options. Petitioner then computed his net gain on the sale by subtracting his original cost basis in the 51,600 shares, increased by the legal fee of $85,000, from the net proceeds realized (Pet. App. A8).

In his notice of deficiency for 1960, the Commissioner determined that there was a completed sale of the entire 206,400 shares of Perfect Photo in 1960, and that, therefore, the gain realized was taxable in that year. In the alternative, the Commissioner determined a deficiency for 1961, asserting that, if the sale was not final in 1960, taxpayer realized gain in 1961 on the sale of 51,600 shares of Perfect Photo in the amount of $986,098.00 (Pet. App. A8).

The Tax Court, in a reviewed decision, unanimously sustained the Commissioner's determination of a deficiency for 1960. It rejected the petitioner's contention that his tender of rescission in that year postponed realization of gain on the sale of his stock until 1961[4] (Pet. App. A31-A38). The Court of Appeals affirmed (Pet. App. A3-A14).

ARGUMENT

The decision below is correct. There is no conflict or any other reason for further review by this Court

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[4] Consistent with its decision that the entire proceeds from the sale were taxable in 1960, the Tax Court determined an overpayment of taxes with respect to 1961. The Commissioner filed a cross appeal from that determination solely to protect the revenue in the event the Court of Appeals reversed the Tax Court's decision with respect to 1960. Contemporaneously with this brief, the Commissioner is filing a protective cross petition for certiorari.

1. Petitioner acknowledges (Pet. 7) that, under the claim of right doctrine (*North American Oil Consolidated* v. *Burnet*, 286 U.S. 417) and principles of annual accounting for tax purposes (now embodied in Section 451(a) of the Internal Revenue Code of 1954 (Pet. App. A2)), funds which are received and held by a cash basis taxpayer under a claim of right are taxable in the year of receipt notwithstanding the taxpayer's repayment of those funds in a subsequent year. Nevertheless, he contends (Pet. 7-13) that both courts below erred in holding that the gain which he realized in 1960 on the sale of 206,400 shares of Perfect Photo stock was taxable in that year. This contention is based on the misconceived notion that his institution of a suit in the latter part of 1960 to rescind the sale of his stock postponed his obligation to report the gain on that sale until 1961 when the suit was settled. Petitioner reasons that the filing of that suit brought him within an exception to the claim of right doctrine that applies when, in the year of receipt, a taxpayer recognizes his liability to repay the amount received and makes provision for repayment.

As both the Tax Court and the Court of Appeals pointed out (Pet. App. A10-A12, A33-A34), however, petitioner was never under any obligation in 1960 to repay the proceeds from the sale of his Perfect Photo stock which he received on July 27, 1960. Indeed, if the market price of Perfect Photo had declined below $20.00 after the date of the sale, petitioner could, and no doubt would, have elected to retain the proceeds of the sale. The repayment of the funds received was entirely within his control. Under these circumstances, no basis exists for the application of an exception to the claim of right doctrine. See *Commissioner* v.

Brooklyn Union Gas Co., 62 F. 2d 505 (C.A. 2), affirmed, 22 B.T.A. 507.

2. Contrary to petitioner's assertion (Pet. 7-11), the decision of the court of appeals does not conflict with the decision in *Sohio Corp.* v. *Commissioner*, 163 F. 2d 590 (C.A. D.C.). In *Sohio*, the court held that an accrual basis taxpayer compelled by state law over its repeated protests to collect certain funds which it at no time asserted a right to retain, was not required to include those funds in its gross income. Here petitioner undisputedly asserted a claim of right (which was never disclaimed) over the sales proceeds from his stock at the time he received those proceeds and, therefore, was correctly required to include those proceeds in the year of receipt.

Petitioner also contends (Pet. 12-13) that the decision below conflicts with the claim of right doctrine as articulated by this Court in *Healy* v. *Commissioner*, 345 U.S. 278. The opinion in *Healy*, however, merely reaffirmed the holding in *North American Oil, supra*, that a taxpayer who receives funds under a claim of right and without restriction as to their disposition is required to take those funds into income in the year of receipt even though it may still be claimed that he is not entitled to retain them and even though he may ultimately be required to restore an equivalent amount. Here petitioner not only received the sales proceeds from his stock in 1960 under a claim of right and without any restriction as to their use, but also had complete control over the decision whether to seek a rescission of the sale. Thus the result reached by the court below is entirely consistent, and may even be deemed to follow *a fortiori*, from the decisions in *Healy* and *North American Oil*.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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JUNE 1973.

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Supreme Court, U. S.
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IN THE

Supreme Court of the United States

October Term, 1972.

No. 72-1539.

KARL and HILDA HOPE,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit.

REPLY BRIEF FOR PETITIONERS.

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REPLY BRIEF FOR PETITIONERS.

This Reply Brief is not intended as a comprehensive rebuttal of all contentions raised by Respondent in its Brief In Opposition.

RESPONDENT'S QUESTION PRESENTED.

The Question As Presented By Respondent is incomplete and too limited. Further, it incorrectly states that there was an "* * * unsuccessful attempt to rescind the sale in that year [1960] * * *". Actually the suit for rescission was still pending at December 31, 1960.

RESPONDENT'S STATEMENT.

Respondent's Statement is both inadequate and redundant. Insofar as 1960 is concerned it fails to note various salient points such as the good faith on Karl Hope's part, conceded *inter alia* in open Court before the Third Circuit Court of Appeals. It is superfluous insofar as it concentrates on the events transpiring in 1961 are concerned, since the very essence of Respondent's "claim of right" position is that 1960 taxability may be determined only by 1960 events and may not be affected by subsequent events.

RESPONDENT'S ARGUMENT.

Respondent concurs with Petitioner that the claim of right doctrine is that "* * * funds which are received and *held* . . . under a claim of right are taxable in the year of receipt * * *" (Resp. Br. 5). Admittedly then Respondent agrees that the claim of right doctrine is not initially applicable unless funds are *both* so received *and held*.

Accordingly it is surprising to find the only bases which Respondent can find to distinguish the asserted conflict with *Sohio Corp. v. Commissioner*, 163 F. 2d 590 (D. C. Cir., 1947) are (1) that unlike *Sohio*, Hope asserted a claim of right at the time of initially receiving the sales proceeds; and (2) the patently erroneous statement that such initial claim "was never disclaimed" (Resp. Br. 6). Having conceded that the proceeds must not only be received but must also be *held* under a claim of right before the claim of right doctrine causing taxation at the close of the year is applicable in the first instance, how then can Respondent justify urging taxation only because there was no disclaimer at the moment of receipt?

It should be noted that at no time, prior to its Brief In Opposition before this Court, has Respondent specifically urged *Sohio* was distinguishable on the above ground.[1] Similarly, neither the Tax Court nor the Court of Appeals relied on this as the basis for distinguishing *Sohio*.

No case has held it pre-requisite to invoking the disclaimer exception to the claim of right doctrine that the taxpayer must have disclaimed at the very moment of receipt. Such a pre-requisite would virtually emasculate the exception, except in rare situations. Indeed, contrary to Respondent, the cases hold that it is sufficient if such disclaimer takes place before the end of the year of receipt and is still being maintained at the end of such year, *United States v. Merrill*, 211 F. 2d 297, 304 (9th Cir., 1954); *Gaddy v. Commissioner*, 344 F. 2d 460, 462 (5th Cir., 1963), aff'g (and quoting from) 38 T. C. 943, 948, 949 (1962); See, *Penn v. Robertson*, 115 F. 2d 167, 175 (4th Cir., 1940).

The decisions of the Courts below in *Hope* are not "entirely consistent" with and do not "follow *a fortiori*"

1. Although *Sohio* was extensively relied on by Petitioners in their original Tax Court Brief, Respondent totally omitted comment on the case in his Original and Reply Briefs.

rom *North American Oil Consolidated v. Burnet*, 286 U. S. 17 (1932) and *E. E. Healy v. Commissioner*, 345 U. S. 278 1953), as was asserted by Respondent (Br. 6). The general laim of right doctrine is a necessary tool to implement the nnual accounting doctrine which requires a determination f taxability as at the end of each year, *E. E. Healy v. ommissioner, supra.* However, the Supreme Court has oted in both cases that the potentially harsh effect of the ıvocation of the claim of right doctrine might at least be itigated by the allowance of a deduction in the year of epayment, *North American Oil Consolidated v. Burnet, upra; E. E. Healy v. Commissioner, supra.* In the *Hope* ase the Courts below have both held that the subsequent ear's recovery of the stock and return of the proceeds ould simply be a repurchase with no deduction allowable, ecause the commencement of the rescission suit was vol-ntary. Further, neither of these two Supreme Court ases involved a disclaimer and a tender back of the roceeds in the year of receipt.

The unsubstantial nature of the distinctions made by Respondent confirm the existence of the conflict and of the esirability of this Court granting certiorari. Moreover, it s striking that Respondent totally failed to comment upon he specific reasons asserted by Petitioners as to why the roper administration of the Federal Tax Laws required eview of the *Hope* case (Pet. For Cert., pp. 14, 15). These easons included questions of public policy, as well as a emonstration that the Respondent here was urging a posi-on to justify taxation of gain which was the opposite of he position espoused in his own Regulations dealing with he allowance of loss under identical circumstances. In-eed, Respondent has confirmed his inability to respond, nd, although these issues have repeatedly been raised by Petitioners, Respondent has always assiduously avoided

response in all his briefs hitherto filed and in his argument before the Court of Appeals.

CONCLUSION.

For the reasons given above and in the Petition For Writ of Certiorari, it is respectfully submitted that this Court should grant the petition for a writ of certiorari to review the judgment of the Court of Appeals for the Third Circuit.

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